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DEREGULATION AND CANADIAN FINANCIAL INSTITUTIONS

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INTRODUCTION

The deregulation of Canada's financial services sector has been taking place in response to growing competitive pressures at both the international and domestic levels. Canadian authorities responsible for introducing these reforms are faced with the challenge of improving the international competitiveness of the financial services sector, without imperiling its traditional stability. The traditional Canadian system of four well-defined banking pillars (banks, trust and mortgage loan companies, insurers and securities firms) is gradually being transformed toward the universal bank model. Although the process of universal banking (offering a wide range of financial services within one institution) is not complete, it has blurred long-standing distinctions between Canadian financial structures and intensified competition in the financial services market-place.

Recent difficulties within Canada's financial services sector (e.g., trust industry failures, loan-loss troubles) do not appear unusual when viewed from an international perspective. The economic boom of the late 1980s has been followed by a recessionary period which has adversely affected many financial institutions around the world. Canadian and American government officials have watched anxiously as competitive processes intensify in their respective countries; both appear uncertain as to the appropriate way in which to combine efficiency and stability in their financial regulatory systems. In recent years, the pace of deregulation in the Canadian financial system has been accelerating at a rate faster than that in the United States. Canada's foray into universal banking, however, has been anything but uneventful, and is producing pressures that may force the Canadian state to make difficult decisions regarding the future of financial activities within its borders.

This paper will examine general issues related to the regulation of financial institutions. It will then provide a brief overview of recent deregulatory initiatives enacted by the Canadian federal government and discuss their implications for Ontario.

GENERAL PERSPECTIVES ON FINANCIAL REGULATION

The traditional system of regulating financial markets had been based on the premise that financial agents would operate predominately in a single country with a closed market in which a relatively stable number of agents would pursue a limited range of activities. Regulations within such traditional systems made it easy to distinguish banking from other financial services. Banking was regulated more intensely than other financial activities since it was placed under the regulatory supervision of central banks, which were to assume responsibility for the actions of their own banks at home or abroad. The consequences of bank failures were thought to centre almost exclusively on a bank's country of origin.[1]

The forces of innovation and internationalization have shattered the basic assumptions of this traditional system of regulation. The differences between banks and other financial institutions have increasingly become obscured. This has contributed to rising domestic competition at a time when international competition is intensifying over an increasingly large range of financial services.[2] The financial revolution that is sweeping the world has been market-driven; shaped by a wide array of new competitors; and heavily influenced by the impact of new technology. It has led to an environment in which competition has driven down profit margins and made risk management (e.g., loans) an even more critical concern of financial firms.[3] The wider scope of banking has complicated matters further. It is no longer unusual for the bulk of a bank's business to be conducted outside its country of origin.[4]

The mobile nature of financial capital and related institutions places pressure on governments to keep their regulations at an acceptable level. Since financial institutions can be located anywhere, governments may be tempted to relax regulations in order to attract or retain these firms.[5] Surprisingly, problems related to regulating this complex environment only emerged as a major public policy concern in the early 1980s.

Simply put, to regulate means to lay down rules. In the field of finance, regulation has grown in an ad hoc and erratic pattern: it has tended to be subjected to periodic overhauls in response to scandals and crises, rather than being rationally planned. Although change under these circumstances can be positive, the costs and difficulties involved in financial regulation appear more justified if rules are designed to achieve pre-determined goals.[6] It is desirable to capture the horse before it escapes from the barn.

During the 1980s, the Canadian public became more aware of efforts to deregulate financial institutions in many industrialized countries. Whether "deregulation" is an appropriate term to describe the new governmental approach to regulation, however, has been subject to considerable debate. Some authors believe that deregulation should really be called "reregulation." They point out that it is not the scrapping of regulations that is the significant issue, but the replacement of one set of rules with another (possibly more lenient) code. Most "deregulation" tends to involve increased regulation somewhere.[7]

American economist Alfred Kahn rejects the idea of "reregulation." In a statement to the U.S. House of Representatives, Kahn stated:

> The curse of our public discourse is our tendency to think and argue in slogans and shibboleths. Time and again, I have seen proposals . . . characterized as "reregulation." "Aren't you simply arguing for a return of regulation?" reporters constantly ask me when I point out that the government has not been fulfilling its responsibilities toward the airline industry.
>
> The answer must be "yes, in a sense, enforcement of the antitrust laws could be regarded as a form of regulation, and so could protecting travellers from deceptive advertising or setting landing fees -- whether efficiently or inefficiently. But that blanket characterization obscures the critical distinction between government interventions intended to make the free competitive market work better and regulations that supplant it and substitute centralized planning -- a

> distinction that communists in Poland and China understand, so why don't you?"[8]

Recent changes in financial institutions appear more to reflect Kahn's market-oriented interpretation, but the often extensive nature of deregulatory reforms should not be underestimated.

Governments are just beginning to come to grips with the challenge of regulating financial systems that have been transformed by the introduction of major technological innovations. For example, currency instability in Europe during the fall of 1992 appears to have been the catalyst for U.S. Federal Reserve Board Chairman Allan Greenspan's recent speech warning that global financial transactions may have become too rapid and complex for bank managers to understand - and for regulators to supervise adequately.[9] Greenspan indicated that the transition from manual banking systems to high-tech split-second electronic systems "may not have been managed by those sufficiently sensitive to credit and risk exposures."[10] He also stated that only after the advent of high-speed banking "did we all become aware that the financial systems were at risk with serious implications for world markets."[11] Although the complexity of current markets appears to be making government regulatory initiatives increasingly incoherent, it may be possible for governments to regain their focus by assessing the degree to which their existing regulatory regimes actually satisfy the principles under which they were initially established.

Financial Theory and the International Scene

From a dry, technical subject, the regulation of financial markets has expanded into an important and controversial political issue. The combination of well-publicized financial scandals (e.g., in the U.K., U.S., and Canada), the stock market crash of 1987, and the obvious need for change in response to the financial revolution, has forced public policy-makers to place their financial sector under greater scrutiny. Ironically, innovating to meet these challenges has also been viewed as making financial systems more unstable.[12]

Many governments have been placing greater emphasis on competitiveness and economic efficiency in an effort to improve their domestic financial conditions. Designing regulations to promote "efficiency", however, can pose serious problems for regulators. Efforts to maintain efficiency in the financial market may threaten efficiency within the whole economy. For example, it may be more cost-effective for financial institutions to restrict their lending activities to major corporations, but this could lead to a capital crisis in the small business sector. Promoting domestic market efficiency can be a form of trade protection that fails to offer foreign firms a "level playing field." Competition can also create instability in the financial sector.

Regulating for both efficiency and stability would appear to be an obvious answer to these problems. For example, through a series of inducements, restrictions, and exchange controls, France tries to be both efficient and stable. It has utilized a system of "positive regulation" which attempts to produce institutions that benefit from international competition without leading to the loss of France's domestic financial centres. Although France has designed regulations to make its financial institutions more efficient, it has also introduced restraint mechanisms that limit liberalization. In addition, although the system encourages foreign institutions to set up distinct subsidiaries in France, they must operate according to French rules and pursue French ends. It is highly questionable whether all of these objectives can be attained simultaneously. Mixing protectionist regulation and increased international competition in a marketplace is loaded with contradictions, and it has placed France in direct conflict with the interests of some of its European neighbours.[13]

In the opinion of many economists, poorly-planned or haphazardly-implemented regulations can have significant adverse effects. For example, loosening the regulatory reins on American Savings and Loans (S&L) institutions in the 1980s apparently encouraged many of these firms to expand their level of risk-taking activities beyond their capabilities and resources. Regulatory compliance costs and potential regulation-related losses of economic activity (fewer transactions than normal) are two more ways in which economic efficiency may be reduced. An additional argument related to regulatory costs is that regulation can inhibit

competition and entry into financial markets thereby reinforcing monopolies or cartels at the public expense.[14]

Whenever competition and efficiency are promoted in financial communities, obvious concerns arise related to insurance and bank failures. Should banks be allowed to collapse in a survival-of-the-fittest contest? To what degree (if any) are governments responsible for bailing them out? The recent American S&L scandal is instructive in this regard. Lawrence J. White, former Federal Home Loan Bank board member, provided the U.S. Senate with a useful description of the problems that can emerge from an effort to deregulate financial services:

> We now know that the origins of this debacle lay in the economic deregulation of the savings and loan industry in the early 1980s. This economic deregulation took place without the necessary accompaniment of stepped up safety and soundness regulation. This distinction between economic regulation and safety and soundness . . . is vital to understanding the nature of the S&L debacle. We got economic deregulation, which was basically sensible. It should have been done. But it created new opportunities for risk-taking, new capabilities for thrifts [or S&Ls] to fund that risk-taking through insured deposits, and there were heightened incentives at that time for hundreds of thrifts to undertake this risk-taking - to grab these risk opportunities - because of the losses they had experienced in the early 1980s.
>
> So this economic deregulation, which was sensible, needed to be accompanied by stepped-up safety and soundness regulation. And, tragically, this was not done at the time. In fact, there were some perverse Federal regulatory actions . . . that actually weakened the existing safety and soundness regulatory system - at just the wrong time.[15]

Emerging from the S&L debacle has been an outcry for more prudential regulation designed to encourage prudent behaviour within the financial system and to deal with the consequences of imprudent or illegal activities. Prudential regulation tends to be the rallying cry of central banks intent on maintaining the stability and/or the safety of

financial institutions and investor funds. The question which remains, however, is whether or not financial institutions should be regulated to eliminate all failures, to prevent systemic failures only, or whether regulators should simply observe market forces from the sidelines.[16]

The complex nature of financial regulation and the trade-offs inherent in its development have led some economists to question the merits of protecting any financial institutions. Professor George G. Kaufman (Loyola University of Chicago) made the following statement before a U.S. Senate Committee in 1989:

> It is also important to recognize that deregulation . . . does not mean no regulation. Rather, it means a transfer from government regulation to market regulation, which is the way all government unregulated industries are regulated. But, as unfortunately was widely overlooked in the early 1980s, for this change-over to work, market regulation and market discipline must be allowed to work. If not, there is truly no regulation or discipline at all -- a sure-fire recipe for financial disaster. And that is what happened with the thrifts [or S&Ls] and must not be permitted to happen with the banks.[17]

Kaufman went on to give an example of the importance of market discipline in the operation of financial institutions and to describe the pressures influencing the attitudes of many politicians when they deal with deposit insurance issues:

> The most important component of market discipline is the penalty for insolvency -- liquidation or reorganization of the firm with losses to shareholders and managers and possibly also to creditors if net worth becomes negative. The penalty for failure restricts risk-taking in unregulated industries. Unfortunately, it has not been permitted to work fully in the thrift [or S&L] and banking industries for a number of reasons. It is often feared that, failures of depository institutions, unlike the failure of other firms, are contagious and spill-over to other, healthy institutions. Moreover, these institutions provide valuable money and credit services and their failure may restrict these services to

> the community. Regulators are frequently evaluated on their success in maintaining stability and delaying reorganization of insolvencies in the hopes that recovery may occur or that total collapse can be postponed to their successor's watch. Elected officials are responsive to their constituents and are biased towards protecting them if the cost can be laid off on a non-constituent, such as federal deposit insurance funds. However, available evidence provides little support for the first two reasons and the high costs of recent policies suggests the folly of postponing hard decisions in the hope that the problem will disappear.[18]

Kaufman supports a plan of higher capital ratios and graduated regulatory supervision to shut down or restructure firms before their capital assets fall below a positive pre-determined figure. This would prevent losses to depositors and to deposit insurance plans.[19]

Some would take Kaufman's ideas one step further. Reducing losses related to the failure of financial institutions is only one aspect of a government's regulatory role. A more serious concern for governments centres on determining what it is they really want financial institutions to do. What is the government's role and purpose in its relationship with the financial industry?[20] In an age when universal banking is breaking down the boundaries between traditional financial structures, it is critically important for governments to have a clearly defined purpose as the basis of their regulatory role and to pursue it with vigilance. As Kaufman indicated in a statement to the U.S. Senate: "The lack of concern over the thrift industry in the 1950s and 1960s contributed greatly to the large magnitude of their problems in the 1980s. Time bombs should be disarmed while they are still ticking and before they explode. That should be the lesson of the S&L crisis."[21]

DEREGULATION OF CANADIAN FINANCIAL INSTITUTIONS - THE 1980s

The pace of change within the Canadian financial industry has accelerated over the last decade and has placed increasing pressure on federal and provincial governments to reform existing regulatory practices. Parti Quebecois Finance Minister Jacques Parizeau launched Canada's deregulatory movement in the mid-1980s with legislation that dramatically reduced restrictions governing the ownership of Quebec's securities industry, and permitted the integration of many financial services.[22] Quebec's reforms (permitting banks, insurers, and trust companies to own securities subsidiaries) were subsequently matched by Ontario and the federal government and became known as Canada's "little bang." These changes were reminiscent of the 1986 "big bang" deregulation of the London Stock Exchange. Of greater significance than the regulatory changes themselves was the extent to which chartered banks took advantage of the new regulatory environment. In a relatively short time (36 months) 80% of the Canadian securities industry came under the control of Canada's major chartered banks, and a variety of foreign banks also acquired Canadian securities firms.[23]

In the wake of the massive banking takeover of Canada's securities industry, it is hardly surprising that Ottawa's proposal to allow banks into the insurance business became a major concern for industry officials. As John McNeil, chairman of Toronto-based Sun Life Assurance, stated at a 1990 shareholders' meeting:

> The government's thrust is to let everyone get into everyone else's business . . . If that's the way things are going then we have to deal with it the best way we can by diversifying into lines of business where we think we have a competitive advantage.[24]

One tactic the insurance industry has used to help it compete with Canada's banks has been to gain affiliations with trust companies. Trust companies give insurance firms access to automatic teller machines, the Canada Deposit Insurance Corporation, and the Canada Payments Association (payment clearing system).[25] The troubled state of

the Canadian trust industry, however, has made it difficult to find financially sound takeover targets.[26]

In the insurance sector, Sun Life and Manufacturers Life have made the highest profile trust company acquisitions:

- Sun Life purchased Coronet Trust Company in 1989 and Counsel Trust Company in 1990.[27] The trust arm of Sun Life has now become the eighth largest in Canada with total assets of more than $3 billion and nine branch offices across the country.[28]

- After failing in its bid to purchase Canada Trustco,[29] Manulife broke into the trust industry in 1990 through the purchase of the Regional Trust Company of Toronto ($82.3 million in assets) and a 50% holding in Huronia Trust ($212 million in assets).[30] In 1991, Manulife extended its trust holdings through the purchase of Cabot Trust Company for $27.6 million.[31]

Twenty-one trust firms are currently controlled by Canadian insurance companies.[32] Obviously many insurance institutions were willing to make significant financial commitments to help ensure that they were well positioned to deal with increased competition in a deregulated financial system.

1992 FEDERAL FINANCIAL REFORMS

On June 1, 1992, the federal government passed its massive revision of legislation governing Canadian banks, trust companies, insurance firms, and co-operative credit associations.[33] The legislation for banks, trusts, and insurers has several common features. Corporate ownership provisions are similar[34] and allow a considerable degree of cross-ownership. For example, banks may own trust companies and insurers, while insurance firms are permitted to own banks and trusts.[35] All three types of institutions can also offer financial services and face similar rules for unfair dealing. The major differences lie in the sections governing the business powers of each type of institution.

Insurance companies are permitted to get into the "business of banking" but are not allowed to take deposits. They are allowed, however, to use a variety of deposit substitutes including term deferred annuities and Guaranteed Investment Certificates.[36] Insurance companies can act as financial agents, receivers and liquidators, and may offer investment counselling and portfolio management services. The new legislation also permits insurers to offer real property brokerage services, credit card services, and to undertake consumer commercial lending in the areas of consumer loans, commercial loans and mortgages.

An insurer is not permitted to

- act as an executor, administrator, or official guardian;
- act as a trustee for a trust;
- accept deposits;
- deal in Canadian securities in violation of federal regulations that the Governor in Council may create;
- make a loan in Canada on the security of Canadian residential property for the purpose of renovating or improving such a property (or refinance such a loan), if the loan and outstanding mortgage exceed 75% of the initial property value.[37]

Regulations concerning the new legislation have not been introduced in their entirety.[38] The regulations that have been introduced restrict the activities of banks and trust companies far more than their insurance industry counterparts. In general terms, the regulations restrict or prohibit banks and trust firms from passing various types of information to their insurance subsidiaries; from targeting specific bank or trust company clients for insurance service promotions; and from occupying premises adjacent to an insurance company or promoting an insurance company in Canada.[39] Banks and trust firms can sell only a few types of insurance such as health (e.g., Blue Cross) and credit insurance.[40]

The new Acts introduce the concept of maintaining "prudent portfolios". Canada's financial institutions are expected to behave like "reasonable and prudent persons" when they establish their standards, procedures, and investment and lending policies in order to avoid losses and to enhance their returns. With a few exceptions (e.g., cross-pillar ownership), the Acts restrict an institution from increasing an investment in a corporate entity beyond 10% of the entity's voting rights for all of its outstanding shares. An institution and a related controlled organization (e.g., a holding company) may possess a combined 25% ownership of a corporate entity's shareholder's equity.[41]

Banks, insurers and trust companies are now permitted to engage in networking arrangements for the purpose of selling any financial service. The only significant barriers to the practice are regulations limiting banks and trust companies in their insurance-related activities. Securities are a different matter, however, since banks, insurers and trust companies are not allowed to handle the primary distribution of shares or debt obligations, or to act as sales agents in relation to the distribution of mutual funds. These institutions are permitted to participate in the distribution of certain government debt obligations, money market securities, and several other debt obligations.[42]

The main business powers of banks, trust companies and insurers are similar in that they may act as financial agents, provide investment counselling and portfolio management services, and issue payment, charge or credit cards. They differ in that a bank has broader power to provide any financial service related to the business of banking.[43]

DEREGULATION AND ITS IMPLICATIONS FOR ONTARIO

In response to federal deregulatory initiatives and the rapidly changing global banking environment, Ontario announced a major review of its financial services legislation in October 1992. Brian Charlton, then Minister of Financial Institutions, indicated in a press release that "problems of duplication and inconsistent standards are raising

serious issues of market efficiency and institutional competitiveness."[44] Ontario's use of the "equals approach", which forces all loan and trust corporations operating in Ontario to comply with its laws (regardless of their jurisdiction of incorporation), may negate the federal government's deregulatory initiatives within its borders and make other provinces more attractive as locations for financial services operations. The Ontario government has participated in interprovincial harmonization discussions over the last two years, but the talks failed to produce a consensus on a number of technical matters before the new federal *Trust and Loan Companies Act* came into effect on June 1, 1992. Ontario may participate in additional interprovincial harmonization discussions in 1993.[45]

One possible regulatory reform discussed by media commentators would allow federal regulators to takeover all regulatory responsibilities for trust companies in Ontario.[46] The willingness of the Ontario government to reduce or eliminate its presence in the trust industry is uncertain, however, especially in view of the fact that Ontario possesses 66% of Canadian trust company deposits and 61% of their investments.[47] The Ontario government may have to decide whether the most efficient and effective regulatory response can be attained from a federal system, a provincial system, or a dual regulatory system. Questions may emerge concerning the past intervention records of Ontario and federal regulatory bodies in terms of their ability to minimize losses from troubled trust firms. Ontario's Superintendent of Deposit Institutions has a reputation for being the toughest regulator in the country while federal regulators have been widely criticized for some of their practices.[48] For example, Ontario regulators were the first to anticipate the Standard Trust debacle and they notified federal officials about the situation.[49] Ontario regulators, however, are still haunted by a series of major trust company failures in the early 1980s (e.g., Greymac, Seaway, and Crown Trust). The conservative approach to reform that has emerged since these failures may no longer be compatible with Canada's current financial environment.[50]

Pressure to reform Ontario's system of financial regulation will likely increase due to the entry of banks and life insurers into traditional trust company territory. Ontario

authorities are also faced with a legislative deadline in regard to permitting continued trust and loan company activities in the province. The current Ontario *Loan and Trust Corporations Act* contains a clause that prohibits loan and trust company activities after July 1, 1996.[51]

CONCLUSION

The Canadian insurance industry appears to have made the most significant gains from the federal government's deregulatory initiatives. Insurers have greater powers in terms of their ability to undertake banking-style activities; at the same time they appear to have kept banks and trust firms from competing directly for their most lucrative business. On the other hand, the entry of insurers and banks (e.g., TD Bank, Laurentian Bank, National Bank)[52] into the trust company business appears to pose the most significant threat to the maintenance of distinctive forms of Canadian financial institutions. Changes in Canada's regulatory environment have even permitted Manulife to transform its three trust firms into the Manulife Bank of Canada.[53] The global trend toward financial deregulation has been growing rapidly and may eventually lead to the dismantling of the few remaining provisions protecting Canadian insurers, banks and trust companies from direct competition in the financial marketplace.

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